

ST 95-36

Tax Type: SALES TAX

Issue: Machinery and Equipment Exemption - Manufacturing

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

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THE DEPARTMENT OF REVENUE      )   Case No.  
OF THE STATE OF ILLINOIS      )   Reg. No.  
      v.                      )   NTL No.  
TAXPAYER                      )   John E. White,  
      ,                      )   Administrative Law Judge  
      Taxpayer.              )  
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RECOMMENDED DECISION

APPEARANCES: Attorney, appeared for taxpayer.

SYNOPSIS: This matter arose after TAXPAYER ("TAXPAYER" or "taxpayer") protested the Illinois Department of Revenue's ("Department's") issuance of Notice of Tax Liability ("NTL") No. XXXXX against taxpayer. In that NTL, the Department assessed tax on taxpayer's use of tangible personal property, to wit: metal cylinders, in Illinois during the period beginning 7/1/89 through and including 9/30/91. Taxpayer claims that its use of the cylinders is exempt pursuant to the Use Tax Act's ("UTA's") manufacturing machinery and assembly exemption ("M & E exemption"). See 35 ILCS 105/3-5(18); 35 ILCS 105/3-50.

At hearing, which was held on June 7, 1995, taxpayer presented testimonial evidence through one of its employees. I have considered the evidence adduced at that hearing, and I am including in this recommendation specific findings of fact and conclusions of law. I recommend that the matter be resolved in favor of the Department.

FINDINGS OF FACT:

1. Taxpayer manufactures and sells purified industrial gas products such as oxygen, nitrogen, argon, carbon dioxide, acetylene, propane, propylene, and mixtures thereof, to a variety of customers, such as dental

clinics, muffler shops, steel mills, etc., for use or consumption. See Hearing Transcript ("Tr.") pp. 10-11.

2. The use tax assessed in this matter was based on taxpayer's purchase price for cylinders, in which the products taxpayer sells are transported to taxpayer's customers in Illinois. Department Ex. No. 1.

3. The cylinders hold products which taxpayer classifies into four general categories: high pressure gases; cryogenic gases; liquid petroleum gases; and acetylene gases. Tr. 12-13.

4. While taxpayer's witness referred to what is contained in a cylinder at the time of sale as being "gas", the product within a cylinder may or may not be in a gaseous state. See Tr. passim.

5. Taxpayer uses different cylinders depending on the type of product sold. Tr. pp. 16-19.

6. The different cylinders are designed and constructed to automatically effect the temperature and pressure changes necessary for the safe extraction of the particular product from the cylinder. See Tr. pp. 12-22.

7. Taxpayer charges its customers per cylinder of product sold. See Tr. p. 14.

8. Taxpayer charges and collects rent from its customers based on the time a cylinder is in a customer's possession. Tr. 14-15.

9. After a customer uses or consumes the contents of the cylinder, it returns the empty cylinder to taxpayer's Hammond, Indiana plant. Tr. p. 15.

10. If a customer does not return a cylinder to taxpayer's Hammond plant, taxpayer bills the customer for the cylinder. Id.

11. Taxpayer did not introduce into evidence a representative or actual copy of any written contract for the sale of purified industrial gas products to Illinois customers.

CONCLUSIONS OF LAW: Section 3-5 of the Use Tax Act provides, in part:

Use of the following tangible personal property is exempt from the tax imposed by this Act:

Manufacturing and assembling machinery and equipment used primarily in the process of manufacturing or assembling tangible personal property for wholesale or retail sale or lease, whether that sale or lease is made directly by the manufacturer or by some other person, whether the materials used in the process are owned by the manufacturer or some other person, or whether that sale or lease is made apart from or as an incident to the seller's engaging in the service occupation of producing machines, tools, dies, jigs, patterns, gauges, or other similar items of no commercial value on special order for a particular purchaser.

35 ILCS 105/3-5(18).

Section 3-50 of the UTA provides, in part:

"Manufacturing process" means the production of an article of tangible personal property, whether the article is a finished product or an article for use in the process of manufacturing or assembling a different article of tangible personal property, by a procedure commonly regarded as manufacturing, processing, fabricating, or refining that changes some existing material or materials into a material with a different form, use, or name. In relation to a recognized integrated business composed of a series of operations that collectively constitute manufacturing, or individually constitute manufacturing operations, the manufacturing process commences with the first operation or stage of production in the series and does not end until the completion of the final product in the last operation or stage of production in the series.

* * *

The manufacturing and assembling machinery and equipment exemption includes the sale of materials to a purchaser who produces exempted types of machinery, equipment, or tools and who rents or leases that machinery, equipment or tools to a manufacturer of tangible personal property. This exemption also includes the sale of materials to a purchaser who manufactures those materials into an exempted type of machinery, equipment, or tools that the purchaser uses himself or herself in the manufacturing of tangible personal property. This exemption includes the sale of exempted types of machinery or equipment to a purchaser who is not a manufacturer, but who rents or leases the use of the property to a manufacturer.

35 ILCS 105/3-50(1).

The Illinois Supreme Court has identified the "gist" of the M & E exemption as being reflected by the following three phrases: "tangible

personal property"; "process of manufacturing or assembling"; and "primarily". Van's Material Co. v. Department of Revenue, 131 Ill.2d 196, 203, 545 N.E.2d 695, 699 (1989). The Illinois Supreme Court has also acknowledged that the legislature enacted the M & E exemption for the purpose of attracting new manufacturing facilities to Illinois, and discouraging existing ones from leaving Illinois. Chicago Tribune Co. v. Johnson, 106 Ill.2d 63, 72, 477 N.E.2d 482, 485-86 (1985); Van's Material Co. v. Department of Revenue, 131 Ill.2d at 215, 545 N.E.2d at 704 ("the purpose of the original statute was to 'give business a tax exemption on capital investment'").

Taxpayer has not supported its claim that the cylinders are primarily used in a manufacturing process. They are not primarily used in a manufacturing process because: (1) the process of manufacturing the products taxpayer sells has ended by the time taxpayer fills the cylinders with the purified products at its Indiana plant; and (2) taxpayer primarily uses the cylinders to store and transport the products it sells to its customers, and to calculate and/or measure its sales and inventory.

The evidence presented at hearing consisted solely of the testimony of taxpayer's director of operations, XXXXX. XXXXX's testimony detailed how the cylinders facilitate -- automatically -- the temperature and pressure changes necessary for the safe extraction of the product from the container. See Tr. pp. 12-22. In some cases, the cylinders effect a change in the physical state of the product (i.e., from the product's liquid state to its gaseous state). Id. XXXXX used the term "gas" to describe the product in the cylinders at the time of sale, although the products in the cylinders may or may not have been in a gaseous state. Compare Tr. pp. 13-14 with Tr. pp. 12, 15-22. While XXXXX testified that taxpayer was in the business of manufacturing and selling purified industrial "gas", the context of his testimony reveals that taxpayer actually sells whatever

particular products are contained in the cylinders at the time taxpayer tenders them for delivery to its Illinois customers. See 810 ILCS 5/2-106(1) ("A 'sale' consists in the passing of title [to goods] from the seller to the buyer for a price."); 810 ILCS 2/2-401(2) ("Unless otherwise explicitly agreed title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods"). Taxpayer introduced no written contracts which would allow me to conclude otherwise.

The Department's M & E regulation provides that "[t]he fact that particular machinery or equipment may be considered essential to the conduct of the business of manufacturing or assembling because its use is required by law or practical necessity does not, of itself, mean that machinery or equipment is used primarily in manufacturing or assembly." 86 Ill. Admin. Code 130.330(d)(2) (1994). While the laws of physics require that taxpayer store and transport its industrial gas products in some type of specialized container, that does not require me to conclude that taxpayer uses the cylinders primarily in a process of manufacturing tangible personal property for sale or lease. That conclusion is not required here because the products taxpayer sells have been fully manufactured before being placed into the cylinders. See 86 Ill. Admin. Code 130.330(d)(4) ("The use of machinery and equipment to store . . . finished articles of tangible personal property to be sold after completion of the production cycle" is not an activity generally considered to be manufacturing).

XXXXX testified that taxpayer charged its customers for each cylinder of "gas" sold. Tr. p. 14. He also testified that taxpayer charged its customers, in the nature of rental, for the length of time each cylinder was in a customer's possession. See Tr. p. 15. If a customer lost or misplaced a cylinder, taxpayer would charge the customer for the cylinder.

Id. There are certain logical inferences to be drawn from XXXXX's testimony. To begin, it is reasonable to infer that taxpayer's customers, in order to avoid paying rental charges for empty cylinders, would keep a cylinder in their possession only until they used or consumed the contents of a cylinder, after which time it would return the empty cylinder(s) to taxpayer (or put the empty cylinders in an area where taxpayer could pick them up at the next scheduled date). It is also reasonable to infer that taxpayer's customers had possession of more than one cylinder, in order to avoid running out of product, and that the time necessary to consume the contents of a single cylinder was less than one billing cycle.

Based on XXXXX's testimony, and the inferences reasonably drawn therefrom, I conclude that most of the time the cylinders were in a customer's possession, the cylinders merely stored the industrial gas products prior to the customer's actual use or consumption of those products. Therefore, and even if the cylinders which effected a physical change in the products taxpayer sold (that is, for those cylinders which, at the turn of a valve, automatically facilitated a change in a product from its liquid state into its gaseous state) could be considered to be used in manufacturing, the time during which those cylinders were used in that capacity appears to have been substantially less than the time during which both taxpayer and its customers used the cylinders to store the products sold by taxpayer. I conclude that taxpayer used the cylinders primarily to store the products it offered for sale, and to transport those products to its customers. The cylinders also appear to be the sole means by which taxpayer calculates its sales and inventory.

Taxpayer argues that the cylinders are no different than the machinery and equipment at issue and described in *Airco Industrial Gas Division v. Department of Revenue*, 223 Ill. App. 3d 386 (1991). See Taxpayer's Brief at 2. The cylinders, however, are distinct from the equipment in that case.

Even more importantly, this taxpayer's primary use of the equipment is distinguishable here. The distinctions are best described by explaining the process by which industrial gas products are manufactured, and the various types of transactions sellers and purchasers of industrial gas products typically enter into. See *id.*

Taxpayer acknowledged at hearing that sellers of industrial gas products conduct business differently depending on the amount of product being sold to a particular customer. See Tr. pp. 6-8. For example, for customers who purchase the greatest amounts, a seller would install a complete manufacturing facility at the customer's location, where extraction, liquefaction and vaporization of the purified gas product occurs. That type of equipment was described in *Keystone Consolidated Industries, Inc. v. Allphin*, 45 Ill. App. 3d 714, 359 N.E.2d 1202 (1977). For customers who purchase intermediate quantities, a seller would begin the manufacturing process at one location, and then transport the discrete liquid elements by tanker truck to a customer's location, where the liquid is pumped into storage vessels, which the seller may, or may not, have installed. That type of equipment was described in *Airco Industrial Gas Division v. Department of Revenue*, 223 Ill. App. 3d 386, and *Liquid Air Corp. v. Johnson*, 240 Ill. App. 3d 722, 724 (1992); see also Department Private Letter Ruling 92-0574.1 For customers purchasing the smallest amount of product, a seller would complete all manufacturing steps at its own facility, then ship cylinders (such as those involved in this matter) of the purified product to its purchasers. This last type of transaction accurately describes taxpayer's business. See Tr. pp. 13-14 (taxpayer's witness XXXXX testified that taxpayer's Hammond plant deals exclusively in cylinder gases).

The most critical distinction between Airco's use of the equipment at issue in *Airco* and TAXPAYER's use of the equipment here is that Airco was

still acting as the manufacturer when it used the equipment at its customers sites.² The machinery and equipment leased or rented in that case was primarily used by Airco to complete, at its customer's sites, the final stage of manufacturing the purified gas products Airco sold. Proof of Airco's primary use of the equipment in that hearing was established by Airco's introduction of its written equipment rental agreements. See Airco, 223 Ill. App. 3d at 387-88. In this matter, unlike the situation in Airco, taxpayer admitted no documentary evidence at hearing indicating that TAXPAYER agreed to perform any manufacturing services at its customer's sites.

Nor did taxpayer set forth a persuasive argument that when one of its customers opened a valve on a cylinder of product purchased from TAXPAYER, that act must be considered a "manufacturer's" use of the cylinder to manufacture the product the customer already purchased from taxpayer.³ And even if I could conclude that a customer's actual operation of a cylinder constituted manufacturing, the evidence at hearing was that taxpayer's customer's purchased the industrial gas products from taxpayer for use and consumption. See Tr. pp. 10-11. Because taxpayer's customers use or consume the products (assuming, for argument's sake) "manufactured" by the cylinders, they would still not be using the cylinders to produce tangible personal property for sale at wholesale or retail. 35 ILCS 105/3-5(18); 86 Ill. Admin. Code 130.330(e).⁴

After reviewing the evidence introduced at hearing, I conclude that the process of manufacturing the products taxpayer sells is completed before those products are placed into the cylinders at issue. Most of the time taxpayer uses the cylinders, it uses them to store the products it sells to its customers. Taxpayer also uses the cylinders to transport the products to its customers, and as a means to measure its sales. The cylinders themselves are used by taxpayer, and by its customers, primarily

for purposes other than for manufacturing tangible personal property for wholesale or retail sale. I recommend, therefore, that the Director finalize Notice of Tax Liability No. XXXXX as issued.

Administrative Law Judge

Date Issued

1. In that private letter ruling, the Department stated:

The manufacture of industrial gases is a process which qualifies as manufacturing for purposes of this [the M&E] exemption. Consequently, machinery and equipment which is used directly in that manufacturing process can qualify for the exemption. For information concerning the extent of the exemption and the manner in which it is claimed, please see the regulation.

P.L.R. 92-0574.

Both the language of the statute and the Department's regulations require equipment to be used primarily -- as opposed to used directly -- in a process of manufacturing tangible personal property for sale at wholesale or retail in order for such use to be exempt under the UTA. To the extent that the Department's use of the phrase "used directly in that manufacturing process" in P.L.R. 92-0574 somehow forms the basis of taxpayer's argument that the cylinders qualify for the M & E exemption, that argument must be dismissed. Primary use, and not direct use, is the yardstick against which taxability is measured. *Van's Material Co. v. Department of Revenue*, 131 Ill.2d 196, 203, 545 N.E.2d 695, 699 (1989); 35 ILCS 105/3-5(18); 86 Ill. Admin. Code 130.330(e).

2. At the administrative hearing in *Airco*, the administrative law judge concluded that *Airco's* use of the equipment was exempt from use tax pursuant to the UTA's M & E exemption. That conclusion was adopted by the Director. I take official notice of the Department's prior determination in *Airco*.
3. I find it impossible to conclude that a dentist who opens the valve on a tank of oxygen, or that a muffler installer who opens the valve on a tank of acetylene, is somehow "manufacturing" the product each is using or consuming.
4. Subsection (e)(1) of the Department's M & E regulation provides:

The statute requires that the product produced as a result of the manufacturing or assembly process be tangible personal property for sale or lease. Accordingly, a manufacturer or assembler who uses any significant portion of the output of his machinery or equipment, either for internal consumption or any other nonexempt use, or a lessor who leases otherwise exempt machinery and equipment to such a manufacturer or assembler, will not be eligible to claim the exemption on that machinery or equipment. No apportionment of production capacity between output for sale

or lease and output for self-use will be permitted and no partial exemption for any item of machinery and equipment will be allowed.

86 Ill. Admin. Code 130.330(e)(1)(1994).